TelFarm Newsletter

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TelFarm Participation Awards

Congratulations to the following farms for reaching these milestones last year and thank you for working with us!

75 Years—

- Brookside Farm LLC—Dowagiac

50 Years—

- Budzinski Dairy Farm—Cheboygan
- Clarkstead Farm—Pittsford
- Ruckle's Farm—Whittemore
- ROD-ER-DIC Farm—Caledonia
- La Pointe Farms—Branch
- Raymond & Audrey Keith—Scottville
- Christensen Farms—Greenville
- Borgert Farm—Sturgis

25 Years—

- Timmer Family Farms—Hopkins
- Altonen Orchards—Williamsburg
- Allen Schmidt Farms—Standish
- Long Family Orchard/Farm— Commerce

Tax considerations when exiting farming

John Jones, MSU & Adam Kantrovich, Clemson Univ.

Selling farm assets can create significant unintended tax consequences

This article was originally published in the May 15 issue of the Michigan Farm News. It's focus was on dairy farms, however, we recognize farms of all types may be struggling and need to consider these same implications regardless of the type.

Starting the Process…

Dairy farmers are having to consider a number of life changing decisions that they never thought would come. Liquidating farm assets can complicate the process due to potential tax liabilities that arise when selling farm assets.

These are difficult decisions to make and the process can be daunting. We will attempt to explain some of the potential tax liability issues that may arise when selling dairy farm assets as there are significant tax consequences that need to be managed.

Once you begin to consider getting out of dairy farming you need to communicate with your lender. There may be clauses within loan documentation that will allow the bank to call in any debt you owe if they feel that:

1. You are divesting of property the bank may hold in collateral or,
2. You are divesting of assets they feel are pertinent to the continuation of the business not allowing the farm to produce the cashflow necessary to pay the loans back

Before you begin the sale of farm assets it is imperative that you communicate with the bank and with tax and legal professionals that understand agriculture and tax code. There are MSU Extension Farm Management agents/educators, that may be available to help answer some questions, explain the potential issues and provide analysis of the situation.

It is important to understand that each farm and situation is unique so this short article will discuss points in general terms. A particular farm situation may be very different than is discussed in this article. Please seek the advice from trusted legal and tax practitioners familiar with these situations.

Business Structure(s) and Balance Sheets

Just like many other businesses, farms may be set-up in one or more business structure(s), such as sole proprietorship, LLC, etc.. The business structure may play a role in the potential tax liability of the farm.

Many farms may have multiple business structures that "own" a variety of the assets of the farm. It is important to identify how you are structured.

Once you have identified your business structure(s) you should develop a detailed balance sheet (one for each entity). The balance sheet will contain the assets (and debt) that each entity owns and this detail will assist in analyzing potential tax liability on the sale of any assets.

This article will focus on the potential tax liability for a sole proprietor, partnership, and LLC's. There are typically fewer farms that have corporations such as a subchapter S or C-Corp that can potentially add additional complications.

Tax considerations when exiting farming, continued

Due to the Tax Cuts and Jobs Act (TCJA), "the new tax law," C-corporations are typically going to have a single tax rate of 21% for the sale of assets, which is different than how many other business structures will be treated.

It is important to understand there are different types of taxes and each will have its own set of code or "rules" and associated tax rates. Some of the more common tax types that would be associated with farm asset sales include:

1. Ordinary/earned income
2. Short- and long-term capital gains and
3. Depreciation recapture

Understanding the different tax types, asset disposition associated with a tax type and the corresponding rates will assist a farm owner to take a more measured approach to when and how to sell or lease/rent an asset to limit tax liability.

Capital Gains

When some assets are sold for a profit, a capital gain/(loss) is generated. Profits or gains are taxable income. How much you'll pay depends on a number of factors, including the current tax brackets, the tax basis of the asset, as well as other variables.

The sale of both raised breeding livestock and purchased breeding livestock as well as other assets can create two different types of capital gain (short-term or long-term), and each has very different tax consequences.

Short-term capital gains are taxed at your ordinary income tax rate for assets generally held less than a year. Long-term capital gains are gains on the sale of assets that were held for more than a year. Breeding cows, bulls and horses are an exception and must be held two years to generate a long-term capital gain.

Asset disposal considerations

Machinery and Equipment and Single-Purpose Building Sales

The sale of machinery, equipment and single-purpose buildings and improvements with a GDS class life of 15 years or less fall under "depreciation recapture."

"Depreciation recapture" is deemed ordinary income "gain" and is taxed at short-term capital gain rates. The sale price of an asset minus the current tax-basis equals the gain.

If the asset is sold for more than its original cost the seller may need to pay different taxes:

1. The ordinary gain rate for the recaptured depreciation and
2. Long-term capital gain for the amount received above the original cost.

Often, the gain on the sale of machinery and equipment will be recaptured depreciation and taxed as ordinary gain.

Special note on trade-ins: Sale amounts above the original acquisition price or basis will also be considered as depreciation recapture on post-1999 traded-in items used in the sold asset's acquisition before long-term capital gain will be allowed.

In lieu of the higher tax liability usually generated on machinery and equipment sales, consider renting or leasing your machinery and equipment out versus an outright sale. Renting or leasing the equipment will not trigger depreciation recapture and will allow for a continued income for years to come.

Building and Improvement of Sales

The sale of buildings and improvements with a 20-year depreciable life or longer is treated as long-term capital gain if the asset was depreciated using the straight-line depreciation method. Long-term capital gain receives a more desirable lower tax rate treatment.

Ordinary gain is only generated on depreciation taken that is accelerated or faster than the straight-line depreciation method's dollar amount over the asset's life. This "accelerated" amount is deemed recaptured depreciation and is taxed as short-term ordinary gain. The remainder of the gain on the sale is treated as a long-term capital gain.

Raised Breeding Livestock Sales

Raised breeding livestock such as cows and bulls that are older than 24 months of age are considered property used in the trade or business and involuntary conversions.

These animals usually carry a zero tax-basis since the cost of raising them has been already deducted as a normal farm expense if you are a cash-basis taxpayer on Form 1040 Schedule F. Late bred close-up heifers, if over 24 months of age, may also be included in this group.

The sale of these raised cows and bulls are taxed as long-term capital gain, which is taxed at a lower tax rate. The entire sale amount is taxable since the tax-basis is zero and is entered in Part I of Form 4797.

The sale of younger raised breeding livestock, heifers and bulls that are less than 24 months of age, are taxed as short-term gain at the ordinary income tax rate and entered in Part II of Form 4797. As raised livestock, they also have a zero tax-basis so the entire sale amount is taxable.

Purchased Breeding Livestock Sales

The sale of purchased breeding stock (heifers, cows and bulls) are treated similar to machinery & equipment for tax purposes.

The gain is considered depreciation recap-

Tax considerations when exiting farming, continued

ture and taxed as ordinary income (self-employment tax is not initiated with breeding stock) as long as the sale price is less than the purchase price. If the animal is sold above the purchase price, the sale price above the original purchase price will be taxed at long-term capital gain rates.

Crops, Feed, Milk and Supply Sales

For a cash-basis taxpayer, crops, feed, milk, and other supplies will normally have a zero cost-basis as the cost of these assets has usually been deducted as a cash expense. Therefore, the sale of feed and crop inventory, feeder livestock, milk and supplies are all taxed as ordinary farm income and is also subject to self-employment (SE) tax which is typically at 15.3 percent up to $132,900 of taxable income.

The SE tax is actually made up of two different tax rates, Social Security and Medicare. The Social Security portion is taxed at a rate of 12.4 percent and is not payable on self-employed income above $132,900 for the 2019 year. The Medicare portion of SE is taxed at 2.9 percent for all self-employed income even above $132,900.

Land Sales

Land may have substantial equity above the mortgaged or debt amount and have unique sale procedures to be met with the creditors. The mortgagees or lien holders will have first claims on sale proceeds on the sale of the real estate. Working closely with your lenders will be important if this is a consideration.

The gain is equal to the sale price, net of selling costs, minus the cost-basis (purchase price or inherited basis less any building depreciation claimed in earlier years). The tax is calculated on the gain and is considered long-term capital gain if the land was owned for more than 12 months. This is generally a lower tax rate than what is paid on ordinary income.

Insolvency issues

If there are insolvency issues that involve possible bankruptcy you need to work with legal and tax professionals familiar with bankruptcy tax laws. See IRS Pub 908 for the treatment of income from the discharge of indebtedness related to Bankruptcy.

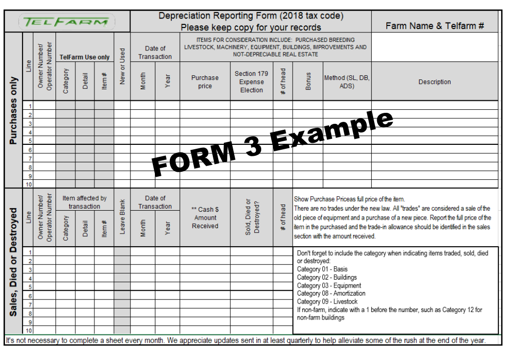
Long-term issues with Cooperative equities and retains

Co-op equities and retains are generally taxed in the year of issuance of the patronage dividend or product sales. They are kept back by the cooperative as equities or retains to provide capital to build and carry on business activities.

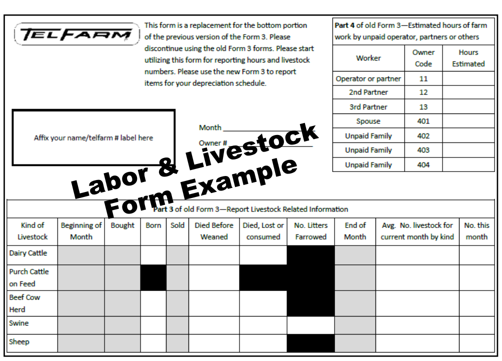
The equities and retains are tax-free when distributed back to the farm in later years assuming they were taxed when issued. This may not necessarily coincide with the sale of the farm and exiting the business.

The full article can be read at https://www.michfb.com/MI/Farm_News/Content/Livestock/Tax_considerations_when_exiting_dairy_farming/

Confusion over Form 3



There have been a lot of changes to our forms in the past few years as we have changed systems and had new tax legislation. We just want to help clear up any confusion on what form you should be sending us. For asset items that are purchased and sold that are included in your depreciation schedule you receive from us at tax planning and tax filing time, you should be using a form that is the size of a normal piece of paper and says Depreciation Reporting Form (2018 tax code) at the top. We have paper copies available that we can send to you, or you can find a downloadable version on our website at www.canr.msu.edu/telfarm/form-3-depreciation/



For those of you that send in hand written records (Form 2), the separate form to report work hours and livestock numbers still applies. Livestock sales information should be reported on Form 2 (NOT Form 3) unless it is breeding stock that is on your depreciation list.

Take notes

Jon LaPorte, MSUE

Planting season is a crucial time to take notes for enterprising or determining costs of production at the end of the year. It can be something as simple as writing a quick note on an invoice, a field map, or even a seed/chemical label they need to keep for your records. For example, if you are picking up fertilizer and have an invoice, writing "corn" or "soybeans" on it can help your record keeper know which enterprise the bill belongs to. Printing a field map and writing the seed variety and planting population or even the chemical program being applied can even help fine-tune your records later on. The key is not to write lengthy notes, but to keep it short and detailed enough to remind yourself which enterprise the input belongs to later on.

Dairy Margin Coverage sign-up starts June 17th

Stan Moore, MSUE

With the signing of the 2018 Farm Bill, dairy farmers got an enhancement to the former Margin Protection Program (MPP) through the creation of the Dairy Margin Coverage (DMC) program. The new DMC program has several improvements that help make it more useful to almost all dairy farmers in Michigan.

DMC is a voluntary program that makes payments when the national average income-over-feed-cost margin falls below a farmer selected coverage level. It is one of the risk management tools that farmers can use, in a market that can have a lot of volatility.

What's new?

The new DMC program features lower premium cost for all milk covered in Tier 1 (under 5 million lbs.). Five million lbs. is equivalent to a farm of 200 milking cows producing 25,000 lbs. of milk per cow/year. Currently, Michigan is ranked #1 in the nation in production per cow at 26,340 lbs. per cow/year (2018).

Farms can now also cover anywhere from 5% to 95% of their production. This means that larger farms can at least cover some of their milk production at Tier 1 prices.

Farms can now select a coverage margin level of up to $9.50 per hundred weight of milk (cwt.) for Tier 1 production. Coverage margin level choices remain at $4 - $8 for Tier 2 coverage.

If farmers sign up for the full five years of the 2018 Farm Bill, they can receive a reduced premium cost. For example, a coverage margin level of $9.50 (Tier 1) has a premium cost of $.15 cwt/year if the farmer wants to be able to change coverage choices each year, but is $.11 cwt/year if they sign up for all five years (5-year discount).

What does all this mean for Michigan dairy farms?

The DMC program allows them to cover a bigger margin between milk price and feed cost, for a cheaper rate when compared to the old MPP. This is especially important to Michigan dairy farmers because they have been impacted by the current low milk prices to a larger degree than other dairy producing states. Because of a current imbalance in production vs. processing capacity in Michigan, dairy farmers here are often receiving over $1 less per cwt. than other states. Causes for this disparity include the increased cost of hauling milk out of the state, and having to sell the milk at a discount in order to find a home for it.

New processing capacity is coming on-line and more is being planned, but these projects take years to accomplish. In the meantime, Michigan led the nation in the percentage of dairy farms that went out of business, from 2017 – 2018, at 13.1% (230 farms).

Decisions producers need to make:

There are three decisions that dairy farmers will need to make:

1. What margin to cover,
2. What percentage of their historical production level to cover, and
3. Whether to sign up for one year or the full five years of the 2018 Farm Bill.

Two key upcoming dates are:

- June 17 – DMC signup scheduled to begin and will stay open until September 20th.
- July 8 –DMC payments scheduled to begin, retroactive to Jan. 1.

Dairy farmers are encouraged to contact their local USDA Farm Service Agency office before the signup start date as they may be eligible to receive a partial refund of MPP premiums pursuant to a farm-bill provision allowing the payback. Producers should visit their local USDA FSA office to discuss any refunds they may be due, and their options in receiving those refunds.

Dairy farmers may also want to view a recent webinar produced by Michigan State University Extension, featuring Dr. Christopher Wolf, Professor - Agricultural, Food and Resource Economics Michigan State University, and Roger Betz & Stan Moore of MSU Extension. The webinar can be accessed through the MSU Extension Farm Management Team's webpage, or by going to the web page address below. http://bit.ly/MSUEDMC

Although the Dairy Margin Coverage program will not solve our current low-price crisis in dairy, it can provide meaningful help to our Michigan dairy farmers. Using the DMC program, along with other risk management tools, can help dairy farmers manage risk on their farms.

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